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California Office of Tourism
Infrastructure and Economic Development Bank
Public Infrastructure Advisory Commission

BUSINESS, TRANSPORTATION AND HOUSING AGENCY

DATE: December 30, 2009
TO: Michael C. Genest, Director of Finance
VIA: FISMA hotline@dof.ca.gov
FROM: Dale E. Bonner, Secretary of Business, Transportation and Housing Agency
SUBJECT: Review of the Systems of Internal Control

In accordance with the Financial Integrity and State Managers Accountability Act of 1983, Government Code Sections 13400 through 13407, I am submitting the enclosed report describing the review of our systems of internal control for the biennial period ending December 31, 2009.

As directed by Audit Memo No. 09-02 issued May 2009, copies of this report are being submitted electronically to the Legislature, the State Auditor, the Governor, and the State Library.

Because our review did not identify any material inadequacies or material weaknesses, we will not be providing you with a corrective action plan.

Should you have any questions, please contact Michael Tritz, Deputy Secretary for Audits and Performance Improvement in the Business, Transportation and Housing Agency, at (916) 324-7517.

Enclosure

cc: Legislature, via Katarina.Tarr@asm.ca.gov
Bureau of State Audits, via MargaritaF@bsa.ca.gov
Governor's Office, via David.Knudsen@gov.ca.gov
State Library, via RFontaine@library.ca.gov

Business, Transportation and Housing Agency
Org Code 0520

A Review of the Systems of Internal Control
For the Biennial Period Ending December 31, 2009

In Accordance with the **Financial Integrity and State Manager's**
Accountability Act of 1983

Prepared By:
Business, Transportation and Housing Agency
Audits and Performance Improvement

December 30, 2009

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Summary

We conducted an internal control review of critical accounting controls and operational controls critical to the accomplishment of the mission of the Business, Transportation and Housing Agency Office of the Secretary (BTH) in effect at the time of our review. Our review was conducted in accordance with the *Guidance for the Evaluation of Internal Control* (Guide) prepared by the Department of Finance (DOF) and *Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors, and included review procedures we considered necessary to determine whether the relevant accounting and operational controls were in place and operative.

In our opinion, the critical accounting controls and operational controls critical to the accomplishment of the mission of BTH, in place and operative at the time of our review, taken as a whole, were sufficiently adequate to ensure that there is not a reasonable possibility that a material misstatement of the entity's financial statements, or that a serious threat to the accomplishment of the mission of BTH, will not be prevented, or detected and corrected on a timely basis.

Our review did not reveal any material inadequacies or material weaknesses. However, it should be noted that, because of inherent limitations in any system of internal control, errors or irregularities may occur and not be detected. Additionally, as a result of changing conditions and the degree of compliance with procedures, the effectiveness of controls changes over time. Specific limitations that may hinder the effectiveness of otherwise adequate system of internal control include, but are not limited to: resource constraints, faulty judgments, unintentional errors, circumvention by collusion, and management overrides. Establishing controls that would mitigate all these limitations would not be cost effective; moreover, an audit may not always detect these limitations.

Introduction

Because governments are susceptible to fraud, waste, and abuse, increased attention has been directed toward strengthening internal controls to help restore confidence in government and improve its operations. In particular, the Legislature enacted Government Code (GC) §13400, which created the Financial Integrity and State Manager's Accountability Act of 1983 (FISMA). FISMA, which is implemented by the State Administrative Manual (SAM) §20000 et seq., charges each state agency with the responsibility of maintaining effective systems of internal accounting and administrative control as an integral part of its management practices. DOF, in its Guide, expands the narrow focus of accounting controls and states that internal control systems embrace the processes and activities an entity engages in to meet its mission and achieve the goals of effectively and efficiently using the organization's resources to accomplish its objectives, complying with applicable laws and regulations, and providing accurate and reliable financial information.

Additionally, GC §13405(a) requires each agency, on a biennial basis but no later than December 31 of each odd-numbered year, to conduct an internal review and prepare a report on the adequacy of the agency's systems of internal control in accordance with DOF's Guide. To comply with FISMA, our review was designed to evaluate the adequacy and effectiveness of critical accounting controls and operational controls critical to the accomplishment of the mission of BTH.¹

Further, this report discusses compliance with GC §12439, which relates to the abolishment of positions that are vacant for six consecutive monthly pay periods, and which allows the DOF to authorize the reestablishment of positions under certain circumstances.

This report fulfills the biennial review requirements for the period beginning January 1, 2008, and ending December 31, 2009.

¹ This evaluation inherently addressed the effective and efficient use of resources, as well as compliance with applicable laws and regulations.

Background

Review Objectives

Pursuant to the requirements of GC §13405, we conducted a review of critical accounting controls and operational controls that are critical to the accomplishment of the mission of BTH.

The objectives of the review were to:

- Determine the adequacy and effectiveness of critical accounting controls and operational controls critical to the accomplishment of the mission of BTH.
- Report on the adequacy and effectiveness of critical accounting controls and operational controls critical to the accomplishment of the mission of BTH, including identifying material inadequacies or material weaknesses in those controls.

Review Scope

The review covered the period January 1, 2008, through December 31, 2009, and focused on critical accounting controls and operational controls critical to the accomplishment of the mission of BTH.

For purposes of this review and report, BTH comprises a policy guidance and administrative oversight function, the California Film Commission, the California Infrastructure and Economic Development Bank, the Small Business Loan Guarantee Program and the Office of Tourism.

It should be noted that the California Highway Patrol (CHP) performs a significant portion of accounting and administrative transactions on behalf of BTH, and, consequently, BTH relies upon many of the controls in place at CHP. Our review did not include a review of the internal controls of CHP; however, we coordinated with CHP to ensure that CHP included in the scope of its FISMA review those transactions that CHP performs on behalf of BTH.

With the exception of not having had a recent external assessment, which has no impact on the overall scope or operation of this internal audit activity, and pursuant to the requirements of GC §13886.5 (a) and DOF's Guide, we conducted this review in accordance with the *Internal Standards for the Professional Practice of Internal Auditing*, published by the Institute of Internal Auditors, and included review procedures we considered necessary to determine whether the relevant accounting and operational controls are in place and operative.

Review Methodology

The review methodology was based on DOF's Guide, and included:

1. Assessing the control environment, including identifying key control considerations that, overall, add value to BTH's systems of internal control.
2. Gaining an overall understanding of BTH and its environment, including its systems of internal control.
3. Performing an organization-wide risk assessment to discover where the greatest vulnerabilities lie, identifying the controls that are or should be in place, and determining where the review should focus. (Described below in greater detail.)
4. Establishing an overall strategy for the review.
5. Developing a detailed review plan.
6. Performing the review work, including observing operations, reviewing documents and reports, conducting interviews, testing transactions, and performing other review procedures as we deemed necessary.
7. Summarizing the material inadequacies or material weaknesses in a report.

In performing the organization-wide risk assessment (number 3 above), the following multi-step approach was used to identify areas where the review should focus:

- First, to gain an understanding of BTH's background and control environment, we:
 - Interviewed staff.
 - Obtained and reviewed background documents, such as organization charts and budget documents.
 - Reviewed the December 2007 FISMA report, which concluded that internal controls were in place and functioning as intended, and identified areas where controls required improvement.

(Note: The only other audit reports issued during the review period were independent auditor reports on the financial statements of the California Infrastructure and Economic Development Bank for the years ended June 30, 2008, and June 30, 2009.)

- Second, to gain an understanding of various processes and management's view of the internal control environment, BTH management and program areas were asked to complete surveys providing information and an assessment of internal controls in the following areas:
 - Cash receipts and receivables.
 - Procurement, contracts, and general business processes.
 - Electronic data security and information technology.
- Third, to leverage organizational knowledge and obtain management's input in identifying and assessing critical accounting controls and operational controls

critical to the accomplishment of the mission of BTH, BTH management was asked to prepare a risk analysis to:

- Identify business functions critical to the accomplishment of the mission of BTH.
 - Identify critical accounting activities.
 - Identify potential risks related to the critical business functions and accounting activities.
 - Identify internal controls in place to mitigate potential risks.
 - Identify significant potential weaknesses in the systems of internal control.
 - Recommend areas for audit based on an assessment of potential risks, mitigating internal controls, and significant potential weaknesses related to critical accounting controls and operational controls critical to the accomplishment of the mission of BTH.
- Fourth, to identify BTH's greatest vulnerabilities to risk associated with the accomplishment of its mission, a matrix was developed to facilitate the review and evaluation of the survey information and organizational risk analysis. Based on our understanding of BTH's mission, mission-critical activities and control environment, and our review and evaluation of the information provided in the surveys and risk analysis, we subjectively classified the critical accounting controls and operational controls critical to the accomplishment of the mission of BTH as having either low, medium, or high risk.

BTH Mission

The policy guidance and administrative oversight function of BTH oversees and coordinates the activities of various constituent departments, offices, and economic development programs with responsibility for maintaining the strength and efficiency of California's infrastructure and financial markets. These entities and programs provide financial and programmatic regulation important to an efficient marketplace and community development, assistance in ensuring patients' rights, and transportation infrastructure for the safe and efficient flow of people and commerce.

BTH Critical Business Functions

BTH's critical business functions include:

- Providing policy guidance and administrative oversight to constituent departments, offices and economic development programs.
- Administering the Tourism Assessment Program.
- Issuing filming permits for all State-owned and -operated properties.
- Administering the California Film and Television Tax Credit Program.
- Financing public infrastructure through the Infrastructure State Revolving Fund Program.

- Providing industrial development conduit bond financing to small manufacturing businesses.
- Providing access to capital for California small businesses through a network of Financial Development Corporations.

BTH Control Environment

In assessing the control environment of BTH, we identified key considerations that contribute to a positive control environment and that, overall, add value to BTH's systems of internal control. Key controls include:

- The establishment of agency goals and objectives.
- The appropriate assignment of authority and responsibility.
- An organizational structure that is periodically evaluated and changed, as necessary, in response to changing conditions.
- A demonstration of integrity and ethical values.
- A commitment to competence.

Vacant Positions

As statutorily required, BTH is in compliance with the requirements of GC §12439.

GC §12439 relates to the abolishment of positions that are vacant for six consecutive monthly pay periods and allows DOF to authorize the reestablishment of positions under specific conditions.

At the end of fiscal year 2008/09, BTH reported nine position vacancies in its Change in Established Positions form (STD 607). Because BTH had diligently attempted to fill the positions but was unable to complete all of the steps necessary within six months, a Request for GC 12439 Vacant Position Reestablishment (DF 155) was subsequently submitted to and approved by DOF for all nine positions.

Risk Assessment

As described in the Methodology section of this report, we performed a risk assessment that was based on the review methodology presented in DOF's Guide to discover where BTH's greatest vulnerabilities lie, to identify controls that are or should be in place, and to determine where the review should focus.

Through our risk assessment methodology, only the Office of Tourism's Assessment Program was identified as having a high degree of vulnerability to risk associated with the accomplishment of BTH's mission; thus, it was the primary focus of our review.

Evaluation of Risks and Controls

In reviewing the areas identified as having the greatest vulnerability to risk associated with critical accounting controls and operational controls critical to the accomplishment of the mission of BTH, we did not identify any material inadequacies or material weaknesses.² Thus, no detailed listing of issues and corrective actions is presented here.

We did, however, identify control weaknesses that were not considered material, and brought them to the attention of management. Our specific findings and recommendations have been presented in writing and discussed with the relevant members of BTH management, and BTH management is taking actions to address our recommendations.

² Consistent with Statement on Auditing Standards No. 115, we consider a material inadequacy or weaknesses to be a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements, or a serious threat to the accomplishment of BTH's mission, will not be prevented, or detected and corrected on a timely basis.

Conclusion

In our opinion, the critical accounting controls and operational controls critical to the accomplishment of the mission of BTH, in place and operative at the time of our review, taken as a whole, were sufficiently adequate to ensure that there is not a reasonable possibility that a material misstatement of the entity's financial statements, or that a serious threat to the accomplishment of the mission of BTH, will not be prevented, or detected and corrected on a timely basis.

Our review did not reveal any material inadequacies or material weaknesses. However, it should be noted that, because of inherent limitations in any system of internal controls, errors or irregularities may occur and not be detected. Additionally, as a result of changing conditions and the degree of compliance with procedures, the effectiveness of controls changes over time. Specific limitations that may hinder the effectiveness of an otherwise adequate system of controls include, but are not limited to: resource constraints, faulty judgments, unintentional errors, circumvention by collusion, and management overrides. Establishing controls that would mitigate all these limitations would not be cost effective; moreover, an audit may not always detect these limitations.

Management Response

Because we determined there were no material inadequacies or material weaknesses that we considered pervasive in their effects on the critical accounting controls and operational controls critical to the accomplishment of the mission of BTH, we did not ask BTH management to provide us with a written response.